
CHAPTER 4 : SUPERANNUATION AND THE AGE PENSION

Lump Sums or Pensions

4.1 Superannuation benefits may take the form of lump sums, life pensions (usually with a reversionary benefit to a surviving spouse), or a combination of the two. Lump sums, in turn, may be used to purchase annuities, or other income streams such as allocated pensions, invested to provide income, applied to the reduction of debt or spent.

4.2 In its background report, summarising retirement income policies in 21 overseas countries, the Committee noted that 'lump sum retirement benefits generally represent a small part of total retirement income'.¹ It went on to point out that, in contrast, Australia exhibited a strong preference to take superannuation benefits in the form of lump sums. It attributed this to:

- . taxation arrangements which historically have favoured lump sum payments over annuities and pensions. The 1988 taxation changes, which included amendments to the RBL, remedied this situation to some extent but anomalies remain;
- . the small size of benefits, particularly for older workers who have only recently received award superannuation. Such benefits would be insufficient to purchase an annuity;
- . the lack of facilities to preserve superannuation entitlements until 1983 when Approved Deposit Funds and Deferred Annuity Funds were created;
- . a perception that lump sum benefits could be used to pay off the mortgage or finance consumer expenditure on change of employment; and
- . a desire to bequeath capital assets.²

4.3 Other attractions of lump sums, depending on individual circumstances, include:

¹ Senate Select Committee on Superannuation, *Super System Survey*, Canberra, 1991, p 1

² *ibid*, p 2

- ♦ *Flexibility.* The retiree has control over the amount and direction of investments and of the amount drawn down each year.
- ♦ *Inflation-proofing.* The retiree may be able to invest the lump sum in such a way as to avoid, or minimise, the erosion of purchasing power through inflation.
- ♦ *Certainty.* The receipt of a lump sum avoids the risk – however slight it may be – of failure to maintain pension payments owing to fraud or fund insolvency.
- ♦ *Double-dipping.* It is often possible for retirees to arrange their affairs so that they can receive a lump sum and retain their eligibility for the age pension.

4.4 From the standpoint of the funds, the payment of lump sums offers a simple and economical means of discharging liabilities, whereas pensions involve regular payments, with associated maintenance of financial and tax records, for many years. Lump sums have the further advantage for fund managers of passing the inflation risk on to the retiree.

4.5 On the other hand, there are distinct disadvantages and risks associated with a reliance on lump sums:

- ♦ *Investment Skills.* Retirees may lack the investment skills necessary to balance income maximisation against risk aversion, to hedge against inflation and to make the sum last the required life span. Some who commence their retirement with those skills may lose them as they grow older. Others may be the victims of incompetent or unscrupulous investment advisers or managers.
- ♦ *Dissipation.* Some retirees will be unable to resist the temptation to spend excessively on such items as holidays and consumer goods. Others may do so as part of a deliberate plan to engage in double-dipping.

4.6 Governments are well aware of the disadvantages of lump sums: if they fail to yield adequate retirement income, whether through a lack of investment skills or through dissipation, the retirees will fall back on the age pension and the relevant superannuation taxation concessions will have been wasted.

4.7 By contrast, benefits taken in the form of pensions or annuities are backed by substantial investments, professionally managed, a regular lifetime income is assured and indexation for inflation can be obtained. Dissipation is impossible and the whole of the benefit is therefore applied to the provision of retirement income.

Proposals for Encouraging the Use of Pensions

4.8 Most of the major participants in the industry, together with the principal departments concerned with superannuation, favoured a strengthening of measures for the encouragement of pensions and annuities in their evidence to the Committee.

4.9 The Alexander Consulting Group proposed that the maximum lump sum should be 20 per cent of the total benefit, subject to a proviso that, where the total value of all benefits was \$50 000 or less, the whole could be taken as a lump sum.³

4.10 Mercer Campbell Cook and Knight expressed the view that further encouragement of pensions and annuities through the taxation system was needed, as well as a widening of the eligibility criteria to enable funds to provide annuities directly to retirees.⁴

4.11 Noble Lowndes proposed that there be no distinction in the tax treatment of the pre- and post-1 July 1983 components of lump sums and that they be taxed as follows:

- ◆ Benefits received prior to age 60, less undeducted contributions, be taxed at 25 per cent.
- ◆ Benefits received after age 60, less undeducted contributions and amounts below the threshold, be taxed at 20 per cent.
- ◆ The threshold for post-60 payments to remain at \$73 776, indexed to AWOTE (Average Weekly Ordinary Time Earnings).
- ◆ Concessional components in respect of permanent and total disablement to be eliminated and the beneficiaries encouraged to take an income stream, subject to the ordinary 15 per cent rebate.⁵

4.12 The Institute of Actuaries was another organisation favouring the use of the tax system to 'give positive encouragement to provision of pensions as opposed to lump sums.'⁶

³ Sub no 61, p 7

⁴ Sub no 79, p 8

⁵ Sub no 80, p 5

⁶ Sub no 108, p 35

4.13 The Accounting bodies, while regarding it as 'logical' that an increased proportion of benefits should be taken in the form of pensions, felt that 50 per cent should remain available in lump sum form.⁷

4.14 AMP favoured a limit on lump sums, determined by way of either a percentage of total benefit or a fixed dollar amount.⁸ The Department of Social Security (DSS) adopted a similar approach, proposing either a 50/50 lump sum/pension split or adopting the current ETP tax threshold (\$73 776) as a lump-sum maximum.⁹

4.15 The Superannuation Economics Research Group of the University of New South Wales did not believe that preferential tax treatment would be successful in achieving a substantial switch to annuities and, in consequence, advocated a regulation requiring all benefits to be taken as annuities, at least to the point at which age pension eligibility ceases.¹⁰ The group also pointed out that, while indexation was necessary in order to counteract the erosion of the purchasing power of annuities through inflation, this requirement substantially increased the price of annuities and therefore reduced their immediate rates of return.¹¹

4.16 In order to overcome this problem, the Group proposed a major change in the structure of government debt. It advocated a substantial increase in the proportion of the debt in the form of inflation-indexed bonds (currently 1.2 per cent of the total) and long-term debt – that is, 15 years or more to maturity (currently less than two per cent). Such a combination would enable annuity providers to 'lock up' their annuity obligations and their supporting government securities and 'throw away the key'.¹² The Committee believes that this proposal has considerable merit and warrants investigation by the Government.

Recommendation 4.1:

The Committee recommends that the Government investigate the possible expansion of long term debt instruments with a view to affording annuity providers greater opportunities to provide lower-cost indexed products.

⁷ Sub no 119, p 20

⁸ Sub no 120, p 13

⁹ Sub no 127, p 12

¹⁰ Sub no 150, pp 19, 20

¹¹ *ibid*, p 20

¹² *ibid*, p 21

4.17 The Treasury, while recognising the 'clear advantages of pensions and annuities from a retirement incomes policy perspective' also recognised a 'legitimate' role for lump sum benefits. It therefore opposed a prohibition on lump sums but supported either a direct limitation on lump sums or an increase in the attractiveness of benefits taken as income streams.¹³

Government Policies

4.18 Governments have so far been reluctant to impose any compulsion to take pensions or annuities instead of lump sums but have relied on taxation measures to achieve this objective.¹⁴ The main provisions, current or proposed, are:

- Higher RBLs where benefits are taken in the form of pensions or annuities. This increases the level of taxpayer support for the relevant contributions.
- Exemption from tax of the income of funds generated to provide pensions or annuities.
- A 15 per cent rebate on the amount of pensions and annuities from taxable funds included in assessable income, that is, the gross amount less the allowable UPP deductions. This will effectively exempt from tax rebatable pensions and annuities up to about \$17 000 per year.
- Previous inconsistencies between the tax treatment of pensions and annuities will be removed.

4.19 The alternative route using compulsion is attractive in its apparent simplicity but would lead to some complications nevertheless. A 100 per cent pension requirement would not yield worthwhile income supplements if the capital sums were small. An arbitrary figure of, say \$20 000, under which lump sums could be drawn, would be required. One could then expect the development of schemes to prevent marginal entitlements from exceeding the cut-off figure. Beneficiaries with entitlements just above the minimum would receive no lump sum at all and would no doubt feel aggrieved.

4.20 A 100 per cent requirement would also rule out the use of superannuation benefits to pay out housing loans and other debts. If exceptions were to be made, questions would arise as to what, if any, upper limit would be

¹³ Sub 195, p 37

¹⁴ The Government's latest proposals are set out in *Security in Retirement*, John Dawkins, Canberra, June 1992

appropriate and how should debts incurred in anticipation of a lump sum benefit should be dealt with.

4.21 Partial requirements, for example 50 per cent in pension and 50 per cent in a lump sum, would offer more flexibility but would still create problems at the margin. If \$20 000 is regarded as minimum worthwhile investment, then the lump sum restriction would cut in at \$40 000, whereas a retiree with a \$39 000 benefit could take the whole as a lump sum. No doubt phasing-in arrangements could be devised to lessen problems of this nature but the result could well be the introduction of a new wave of complexity in an already over-complex area.

4.22 On balance, the Committee endorses the policy of encouraging pensions and annuities through the tax system and welcomes the simplification measures announced in *Security in Retirement*. However, it believes that, in conjunction with the research into retirement ages and double dipping recommended in Chapter 3, the extent and application of lump sum benefit payments should be monitored with a view to the imposition of specific regulation if the taxation measures should prove to be ineffective.

Allocated Pensions

4.23 According to the DSS, fewer than one per cent of retirees use their lump sum benefits to purchase lifetime annuities, notwithstanding their official encouragement.¹⁵ The low figure is no doubt a reflection of the perceived disadvantages of annuities, notably their relatively low return and consequent high cost, and the lack of residual value, even in the case of early death. In response to these perceptions, a market has developed over the last six years for a less rigid form of annuity known as an allocated pension or cash-back pension.

4.24 These pensions may be purchased from ETPs or rollover funds and take the form of individually managed investments which may be drawn down at rates determined annually by the beneficiaries, but within stipulated minima and maxima, determined as follows:

$$\text{Minimum drawing} - \frac{AB}{PVF}$$

$$\text{Maximum drawing} - \frac{AB}{PVF/80}$$

¹⁵ Sub no 127, p 16

where:

- **AB** is the individual's fund balance as at 1 July each year;
- **PVF** is the Pension Valuation Factor published by the ISC for the age of the person each 1 July, that is , the annuity factor for a CPI-indexed, 85 per cent reversionary annuity payable for life; and
- **PVF/80** is the annuity factor for a non-indexed, non-reversionary annuity payable to age 80.

4.25 If the pensions meet these standards, they are treated as superannuation funds, in that the investment income is not taxed as such, but is treated in the same way as annuity income when drawn.

4.26 Allocated pensions thus have the taxation and professional management advantages of annuities and any undrawn balances on death can be disposed of by will. There is no provision for a guaranteed rate of return and no indexation to compensate for inflation, consequently returns tend to be higher than for annuities. They are thus a half-way house between privately managed investments and purchased lifetime annuities and have been growing in popularity. According to AM Corporation, one of the main providers of allocated pensions, allocated pensions have now captured more than half of the total annuity market, as shown in Table 4.1.

Table 4.1 RETIREMENT INCOME STREAMS – NEW BUSINESS AND TYPE¹⁶

Income Stream Type	Quarter Ending 31/3/92	% of Market	Quarter ending 30/6/92	% of Market	Quarter ending 30/9/92	% of Market
Term annuity	31.31	16.62	26.34	15.14	23.20	11.56
Term Annuity with RCV	70.72	37.54	76.60	44.04	60.94	30.36
Total term annuities	102.03	54.16	102.94	59.18	84.14	41.92
Lifetime Annuity	19.36	10.28	12.34	7.09	12.49	6.22
Total Annuities	121.39	64.44	115.28	66.27	96.63	48.14
Allocated pensions	66.98	35.56	58.67	33.73	104.12	51.86
TOTALS	188.37	100.00	173.95	100.00	200.75	100.00

¹⁶ Sub no ST 17, attachment

4.27 As allocated pensions further the Government's objective of using superannuation benefits for the provision of regular income streams, the taxation advantages attaching to pensions and annuities have been extended to them.¹⁷

4.28 The rationale behind the Government's thinking was amplified by an ISC Assistant Commissioner at a recent superannuation conference. Among his observations, the following are significant:

- . The marketing of allocated pensions coincided with policy decisions by Government in 1989 and 1990 to send clear signals to the industry that it preferred benefits to be taken more in income stream form.
- . The dimension that allocated pension brought to the policy problem was to force policy advisers to address the question as to what is acceptable as an income stream for retirement income purposes.
- . To confine the meaning of income streams to a traditional pension or annuity would be to unnecessarily narrow it *to the detriment of policy* [emphasis added].
- . The definition [of a retirement income stream] ... should be general in its application.
- . The key characteristics [of a retirement income stream] are that the payments must be made at least annually ... must be greater than a prescribed minimum ... and ... less than a prescribed maximum [see paragraph 4.24].
- . Providing the payments satisfy these requirements, they would be considered a superannuation pension or rollover annuity and, accordingly, a retirement income stream.
- . This approach ... encompasses both traditional pensions and annuities as well as income streams where the future pension or annuity payments are not defined at the time the pensions commence to be paid.¹⁸

4.29 The Government has thus taken a positive decision to define annuities in a manner which embraces allocated pensions in furtherance of its policy of encouraging income streams in preference to lump sums. The definition would be brought into effect through the tax system.

¹⁷ *Security in Retirement*, op cit, p 10

¹⁸ Mike O'Neill, *Allocated Pensions: Are they Set to Boom?* address to ASFA National Superannuation Conference, October 1992, pp 1-2

Allocated Pensions and Social Security Legislation Amendment Bill (No 3) 1992 Divisions 16-19 (inclusive)

4.30 Under the proposed amendments to the *Social Security Act* the Government will treat both unrealised capital gains and income applying to the assets underlying allocated pensions as earned income for the age pension means test, notwithstanding their exemption from income tax in the same way as the supporting assets for annuity incomes. Furthermore, the capital value of allocated pensions will be included in the assets test, whereas that of annuities is disregarded.

4.31 The Department of Social Security (DSS) rationale for the revised treatment is:

- it brings the treatment of allocated pensions into line with other types of similar investments;
- it is consistent with the principle that the decision to defer receipt of income until a later date is a personal one, rather than one which should be supported with a higher rate of pension; and
- continuing to assess allocated pensions on a receipts basis when the investor can vary the payments and determine when income is received could encourage investors to defer receipt of income.¹⁹

4.32 DSS further contended that the main impact of the legislation would be that, for those with investments below the assets test thresholds, it would bring forward the assessment of income to when it is earned, rather than when it is received.²⁰

4.33 In clarifying its position regarding the treatment of term annuities compared to the proposed changes in treatment of allocated pensions, DSS stated that it would be reviewing the treatment of the former by the end of January 1993.²¹ The Committee will maintain an interest in this review process.

4.34 Under the operation of the income test, each \$200 per year of assessed income above the threshold has the effect of reducing the age pension by \$100 and, under the assets test, each \$1 000 of assets above the threshold brings a

¹⁹ Sub no ST 17, p 2

²⁰ *ibid*

²¹ *ibid*, p 39

pension reduction of \$104 per year. DSS estimated that the change in the treatment of allocated pensions would save about \$2 million in a full year.²²

4.35 DSS also told the Committee that it was 'not necessarily the case' that the tax and social security treatments of particular investments needed to be identical. Although allocated pensions had many features in common with complying superannuation pensions, they should, on balance, be subject to the standard social security procedure of treating income on an accrual basis.²³ 'What we are attempting to do is provide neutral treatment vis-a-vis other similar sorts of investments.'²⁴ The justification for the change given in the Explanatory Memorandum accompanying the Bill was that, as drawings were variable, allocated pensions operated 'in a similar way to a bank account ... at the recipient's discretion'.²⁵

4.36 AM Corporation submitted to the Committee a schedule showing how each retirement income vehicle would be affected by the new rules (See Table 4.2). According to AM, the Bill would reduce the pension entitlement of certain persons by over \$2 600 per year.²⁶

4.37 AM Corporation proposed an amendment for the legislation which, amongst other things, excluded allocated pensions and annuities from the new definition of 'managed investment' as proposed in the Bill, that is, allowing these products to be treated in the same way as all other superannuation products and annuities in respect of both taxation and social security treatment.²⁷

4.38 In a supplementary submission, DSS estimated that the cost of AM's proposal, relative to the provisions of the Bill, would be between \$13 million and \$20 million by 1996-97, giving a cost over the next five years of between \$50 million and \$77 million.²⁸

²² ST evidence, p 34

²³ *ibid*, p 38

²⁴ *ibid* p 41

²⁵ Social Security Legislation Amendment Bill (No 3) 1992, Explanatory Memorandum, p 76

²⁶ Supplementary evidence, sub no ST 17

²⁷ ST evidence, pp 30-34

²⁸ Sub no ST 18, supplementary submission of 3 December 1992. DSS used rates of return of seven and ten per cent in making these estimates and assumed that the allocated pension market would continue to grow at current rates.

Table 4.2

RETIREMENT INCOME STREAMS**DSS TREATMENT****An Example**

An individual commences an annuity or allocated pension using the following superannuation benefit:

	\$
Pre Component	50 000
Post Component	<u>50 000</u>
Total Rollover	100 000

Life expectancy is say 15 years and the allocated pension earns 10% investment income. A pension or annuity or drawn-down payment of \$8 000 is made in the first year.

Retirement Income Stream	Assets Test \$	Income Test \$	DSS Pension \$
Allocated Pensions/Annuities			
Current rules	Nil	4 667	6 737
Proposed rules	100 000	10 000	4 085
Life Annuities			
(Current rules)	96 667	1 133	7 959
Term Annuities (15 years, nil RCV)			
(Current rules)	96 667	1 333	7 959
Term Annuities (15 years, 100% RCV)			
(Current rules)	100 000	8 000	5 073
ADF Drawdowns (pre age 65)			
Current rules	100 000	10 000	4 085
Proposed rules	Exempt	800	7 959

Unrealised Gains and the Income Test in Relation to the Social Security Legislation Amendment Bill (No 3) 1992 Divisions 16-19 (inclusive)

4.39 The Government proposes to amend the Social Security Act to provide that net unrealised capital gains on listed securities, other than bonds and debentures, should be brought to account in the income test in the same way as now applies to managed investments. Losses on similar investments accruing during the same period will be allowable as an offset against these profits.

4.40 In foreshadowing this change to the 1992-93 Budget papers stated that:

The assessment of income for income testing purposes will be expanded to include accruing capital gains and losses made *during the previous twelve months* on listed shares and other securities (hitherto only dividends have been assessed)... [emphasis added]²⁹

4.41 A concurrent statement by the Department of Social Security stated that: 'Capital growth on shares will be included under the income test ... any losses ... will be allowed to be offset against any gains on shares.'³⁰ A subsequent press statement by the Minister, Dr Blewett, stated that the proposed change 'treats the capital growth of shares as income and enables shareholders 'to offset capital losses against gains'.³¹

4.42 The Committee believes that a reasonable interpretation of these statements is that:

- the dollar amount of capital gain over the twelve months prior to assessment date is to be treated as income, together with any ordinary distributions, which are already assessable;
- where two or more different investments are held, the net capital gain from the portfolio as a whole, together with total distributions, is assessable;
- capital losses may be offset against dividend income;
- if, over a period, there is no net capital gain, there should be no assessment of income; and
- changes in values prior to acquisition, or prior to the holder becoming a pensioner, whichever occurs later, are disregarded.

4.43 The Committee believes that this interpretation is fair, logical, simple and equitable, given the acceptance in principle of the assessment of unrealised gains. It requires no calculation beyond simple addition and subtraction and implies no assumptions about the future.

4.44 The decision is being put into effect by amendments to the *Social Security Act* 1991, contained in Division 18 of the Social Security Legislation

²⁹ *Budget Statements 1992-93: Budget Paper No 1*, p 3.97

³⁰ *DSS 1992-93 Budget Information*, p 57

³¹ Minister for Social Security *Media Release No 46/92*

Amendment Bill (No 3) 1992. Clause 116 of the Bill sets out the formula to be used in assessing the gains and losses for the purposes of the means test.

4.45 The Council on the Ageing (COTA) raised several objections to the proposal:³²

- ♦ Fixed interest investment provides pensioners with the bulk of their private income and, as no capital growth accrues to such investments, they cannot be compared with shares.
- ♦ Pensioners should have the right to invest in shares as a hedge against inflation.
- ♦ While unrealised gains result in pension loss, there is no penalty if the shares are sold and the growth realised.
- ♦ If unrealised growth exceeds dividends, a pensioner will have a negative cash flow.
- ♦ It is unfair to assess a benefit which may never eventuate.
- ♦ Applying an income test to what is obviously an increase in capital is unacceptable.
- ♦ It is inequitable not to include an inflation adjustment.
- ♦ Unrealised losses can be set off only against gains in the same period but, as share prices usually move up and down together, there will be very limited opportunity for offsets.
- ♦ The formula exaggerates gains and understates losses, so that, even if these cancel out over an investment period, assessable income is deemed to have occurred.

4.46 The Australian Stock Exchange and the Institute of Actuaries tendered similar criticisms.³³

4.47 The DSS responded to the effect that:

... shares are just being brought into line with other forms of investments which are assessed on an accruing basis;

³² Sub no ST 22

³³ Sub no ST 23 and ST 25

Real estate is far more difficult ... unlisted securities are an administrative problem ... shares are much easier to address; and

[If there is a general rise in share prices but no change in dividends] the person is then in a situation of needing to make a choice ... whether just to let things go or whether he needs to recoup that in some other way, perhaps by utilising other assets or selling some proportion of his shares.³⁴

4.48 In relation to the timing of valuations of securities held by part pensioners, DSS advised that the Department would be 'doing reassessments every quarter. That will be done automatically...' on the basis of data purchased indicating movements in share prices.³⁵

Income Test and Income Taxes

4.49 Eligibility for the age pension is subject to meeting means tests on both income and assets. The tests are applied independently and the amount of pension is governed by whichever test produces the lower pension.

4.50 The income test, as applying at 30 June 1992, provided that each dollar of weekly income in excess of \$42 (single) or \$74 (couple) resulted in a reduction of 50 cents in the pension. The effect of this test on pensions is shown in Table 4.3.

Table 4.3 – Effect of Income Test on Age Pensions³⁶

	Single Person		Married Couple	
	\$ per	\$ per year	\$ per week	\$ per year
Full pension:	153.05	7 959	255.30	13 276
Allowable non-pension income:	42.00	2 184	74.00	3 848
Means test threshold:	195.05	10 143	329.30	17 124
Pension ceases at non-pension income of:	348.00	18 096	584.00	30 368

4.51 Thus, increases in non-pension income, for example from annuities or investments, within the allowable limits, are fully reflected in the disposable income of pensioners. Using multipliers derived from current annuity rates (see Table 4.4 below), it can be shown that means-test free incomes may be derived

³⁴ ST Bills evidence, pp 34, 35

³⁵ ST Bills evidence, p 35

³⁶ Source: Department of Social Security

from investments of up to about \$26 000 (single male), \$33 000 (single female) and \$60 000 (married couple).

Table 4.4 : Immediate Annuities per \$100 000³⁷

	Single Life Guaranteed 10 years CPI Indexed		Joint life and survivorship (85% payable to survivor) Guaranteed 10 years CPI Indexed
	Male 65 \$ pa	Female 65 \$ pa	Male 65/ Female 60 \$ pa
AMP	8 035	7 094	6 282
Friends'	8 416	7 480	6 695
L&G	7 762	6 844	6 010
Mercantile Mutual	7 929	6 669	5 575
National Mutual	6 762	5 797	4 342
Norwich	8 099	7 208	6 493

4.52 Using the same multipliers, it will be seen that the pension cut-off points will be reached with investments of about \$220 000 (single male), \$270 000 (single female) and \$480 000 (married couple).

4.53 It is therefore clear that, for the foreseeable future, the great majority of retirees will continue to be eligible for, and can be expected to apply for, age pensions, whether full or part. They will be affected by, and sensitive to, the income means test, which reduces any increase in non-pension income above the threshold by 50 per cent through pension reductions.

4.54 The Government announced in 1989 that, by 1995, all age pensioners, both full and part, will be exempt from income tax. Until then, the following provisions³⁸ will continue to apply:

- Age pensions, along with other incomes, are subject to tax.
- Full pensioners receive a tax rebate equal to the tax otherwise payable on incomes up to the means test threshold, effectively making such incomes tax free.
- Income in excess of the thresholds is subject, firstly, to a pension reduction equal to 50 cents for each dollar. The remaining 50 cents is subject to income tax at 20 per cent, or ten cents.

³⁷ Source: *Personal Investment* December 1992, p 68

³⁸ Rates used for illustration are those applicable to the 1991/92 financial year

- The pensioner tax rebate is reduced by 12.5 per cent of the additional net income, or 6.25 cents of each 50 cents increase net of means test.
- Initial income in excess of the thresholds is therefore subject to a combined pension withdrawal and tax rate of 50c + 10c + 6.25c per dollar, or 66.25 per cent.
- When non-pension income reaches \$5 561 (single) or \$7 691 (couple), Medicare levy becomes payable at a phase-in rate of 20 per cent, or ten cents of each 50 cents remaining after the means-test pension reduction.
- This phasing-in of the Medicare levy raises the withdrawal and tax rate to 76.25 per cent.
- At non-pension incomes of \$7 127 (single) and \$10 229 (couple), the Medicare levy reverts to the standard rate of 1.25 per cent,³⁹ or .625 cents out of 50 cents, bringing the withdrawal and tax rate down to 66.875 per cent.
- The pensioner rebate cuts out at \$17 102 (single) and \$23 624 (couple), reducing the withdrawal and tax rate to 60.625 per cent, a rate which is maintained until the pension cuts out at \$18 096 (single) and \$30 368 (couple).

4.55 The foregoing summary illustrates firstly, the great complexity of the taxation of part pensions, secondly, the abrupt changes in impact and, thirdly, the high combined impact of pension withdrawal and taxation. These range from 60.625 per cent to 76.25 per cent on non-pension incomes above the means-test threshold and average 67.3 per cent over the whole range of part pensions. This contrasts with the marginal tax rates, including Medicare levy, payable by general taxpayers of 21.25 per cent for incomes up to \$20 700, and 39.25 per cent on additional income up to \$36 000. The maximum marginal rate for general taxpayers is 48.25 per cent for that part of income which exceeds \$50 000.

4.56 Many pensioners, faced with the loss of two-thirds of any investment income through the combined effects of the means test and income tax, are likely to be deterred from making investments to supplement their pensions. There will be a strong temptation to organise their affairs in a manner which maximises their pension incomes.

³⁹ The Medicare levy was raised to 1.4 per cent in the 1992/93 Budget

4.57 In announcing the proposed tax exemption for part pensioners, the Government stated that its purpose was 'to remove disincentives to individuals undertaking retirement savings and thereby to encourage greater self-provision in retirement'⁴⁰ and commented that the combined effects of pension withdrawal and income tax:

... not only distort savings and investment behaviour of pensioners and those saving for retirement, but also cause resentment, confusion and compliance difficulties for pensioners facing two separate systems of administration.⁴¹

4.58 The Committee endorses this view and welcomes the decision to exempt all age pensioners, both full and part, from income tax. However, it should be noted that, even then, those pensioners will still be confronted with the pension withdrawal rate of 50 per cent, a rate which could discourage self-provision for retirement.

4.59 Incomes of those of pensionable age immediately above the pension cut-off point of around \$18 000 would, in the absence of special provisions, be subject to tax of about \$2 500. In order to smooth out the taxation rates on incomes above the pension limit, it will be necessary to phase out the rebate until it reaches zero and the ordinary tax scale is reached. This need was acknowledged by the Treasurer in a written reply to a question in the Senate.⁴²

4.60 If the rebate is phased out at a rate which maintains the marginal tax rate at the pension withdrawal rate of 50 per cent, the ordinary tax scale would not be reached until a taxable income of about \$47 000, an unacceptably high figure. As ordinary tax rates (including Medicare levy) rise from 21.25 per cent to 39.25 per cent at \$20 700, it might be appropriate to increase the marginal tax rate to 60 per cent at that point. In this event, the rebate would cease at around \$30 000, or roughly AWE.

4.61 The position with regard to married couples is a little more complex, but clearer if attention is directed towards the desired outcome rather than the process of reaching it. Each partner receives a pension somewhat lower than single pension and each is taxed separately. Pensions cease to be payable when combined income is a little over \$30 000, or \$15 000 each. Assuming non-pension income is equally spread, the application of the formula suggested above would commence at about \$15 200 and the rebate phase out at \$23 500. Complexities arise when non-pension income is unequal, where the income of

⁴⁰ Budget Paper No 1, 1989-90, p 4.9

⁴¹ *ibid*, p 4.10

⁴² Senate *Hansard*, 12 October 1992, p 1619

one partner may exceed the top of the second taxation bracket and where spouse rebates may be involved. However, it should be possible to ensure an outcome for married couples consistent with the formula.

Recommendation 4.2

The Committee recommends that the Government proceed with its announced intention to rebate all income tax otherwise payable by age pensioners.

4.62 Whilst implementation of the Government's proposal supported by these measures would certainly result in an immediate loss of revenue, to the extent that they encourage the generation of additional non-pension income, revenue would benefit by 50 per cent of that additional amount through savings in pension payments.

Means Test — Assets

4.63 A means test is also applied to assets, other than the principal residence, of pension applicants and recipients. Assets in excess of \$110 750 (single) and \$157 500 (married) have the effect of reducing the pension at the rate of \$104 per year for each \$1 000 of assets. Higher limits are set for non-homeowners: \$190 250 (single) and \$237 000 (married).

4.64 The same pension reduction – \$104 per year – results from an increase in income of \$208 per year as results from an increase in assets of \$1 000. The implicit earning rate on assets is therefore 20.8 per cent. This rate is unrealistic when government bond rates are around eight to nine per cent, cash management funds around five per cent and bank term deposits around six to seven per cent. The deeming rate on bank balances for age pension purposes is currently five per cent.

4.65 The holding of assets is thus heavily penalised in contrast with their income equivalent. As the test least favourable to the pensioner is applied, once assets exceed the means test threshold, the assets test will be the determinant of pension eligibility. Is this designed to encourage annuities as against bequests?

4.66 So severe is the test that investments over the threshold amount of \$110 750 will actually cost more in reduced pension than the income earned, except in the unlikely event that returns exceed 10.4 per cent.

4.67 Some commentators have argued that the means-test threshold is very generous and that, in consequence, the pension attrition rate must of necessity be steep to prevent access to pensions by the wealthy. But if that is the case, the proper course of action would be to reduce the threshold to a level comparable to the income threshold, with an additional allowance for household and personal possessions which cannot be expected to earn income.

4.68 If that could be achieved, it would then be both possible and desirable to link the income and assets tests via a realistic interest rate – for example, the deeming rate on bank balances. Where assets included bona fide investments in income-earning ventures, such as farms, small businesses or equities which were actually yielding less than the deeming rate, such lower earning could be the amount subject to the test.

Recommendation 4.3

The Committee recommends the assets test be aligned with the income test via the application of realistic, market-related interest equivalents, subject to:

- (a) a reasonable allowance, for example \$50 000, for personal and household possessions; and
- (b) inclusion of actual income on bona fide income-earning assets.

Tax Inconsistencies

4.69 To the recipient of a part pension, reductions in net income, whether by way of pension attrition through the means test or by way of income tax, attrition of pensioner rebate or Medicare levy are identical in impact – all transfer income from the pensioner to the Government. It follows therefore that a smooth transition from dependence on the age pension to fully self-funded retirement will be facilitated where definitions, concepts and practices are consistent as between the taxation and social security legislation.

4.70 For example, tax law treats each individual separately: the incomes of husband and wife are taxed independently, although a rebate is allowed for dependent spouses and any unused pension rebate is transferable. By contrast, for age pension means test purposes, all income and assets are allocated equally to husband and wife, irrespective of the actual income earner or asset owner. This difference makes financial planning more complex and can lead to

inequities where, for example, a married superannuation pensioner may be fully taxed on a single income, whereas an age pensioner couple on the same income might pay lower, or even no, tax.

Recommendation 4.4

The Committee recommends that the Treasurer and the Minister for Social Security form a working party to examine income tax and social security legislation with a view to maximising the consistency of definitions and treatment of matters of common concern to the two systems and that the report be tabled in Parliament by the end of 1993.